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INSIGHT

MONTHLY COMMENTARY

Year End Credit Update

TAMMY KARP | JANUARY 9, 2018

2017 was a good year for the credit markets. Tax reform, a rebound in commodity prices and subsequent improvement in earnings were all supportive of risk assets. But the driving force behind the demand for spread product has been the unprecedented amounts of central bank accommodation which has been a major tailwind for the risk markets. Technicals have been a dominant theme as the QE-led quest for yield has pushed investors down the risk spectrum, thereby allowing companies to issue record amounts of debt.

The Bloomberg Barclays U.S. Investment Grade Credit Index has grown by $3.7 trillion since 2009, a CAGR of 11%. Credit now accounts for 30.59% of the Bloomberg Barclays Aggregate Bond Index, up from 21.5% in 2009. Emblematic of a late stage part of the cycle, valuations are stretched and fundamentals have deteriorated. Credit spreads are at post-crisis tights (OAS of +89) and well inside historical averages. Corporate leverage has climbed to new highs, having steadily increased since the post-crisis trough of 2011. With net debt/EBITDA at 2.31x, as of the end of 3Q17, leverage for the non-financial IG universe has increased more than a full turn since the beginning of this cycle. Only 21% of the non-financial IG universe (by market value) is levered less than 1x, compared to 40% just five years ago. While fewer companies are lower levered, more companies are highly levered with 30% of the non-financial IG universe having more than 3 turns of net leverage (vs. 19% in 2012). What's more, 12% of companies are levered more than 5x – double what it was five years ago. That amounts to nearly $400 billion worth of debt that could be at risk of falling into high yield – relative to a $1.3 trillion U.S. high yield market.

While corporate tax cuts and overseas earnings repatriation are positives, this stimulus comes late in the cycle – i.e., when spreads are tight, leverage is high and the size of the debt markets are massive. Moreover, central banks are beginning to tighten/unwind after years of extraordinarily accommodative policy. From a risk/reward standpoint, a conservative approach to credit is still warranted. That means investing in credits with stronger balance sheets, less cyclicality and lower re-leveraging risk. It also means sticking to the most senior parts of the capital structure, especially as skinny subordination premiums offer little compensation for the risk.

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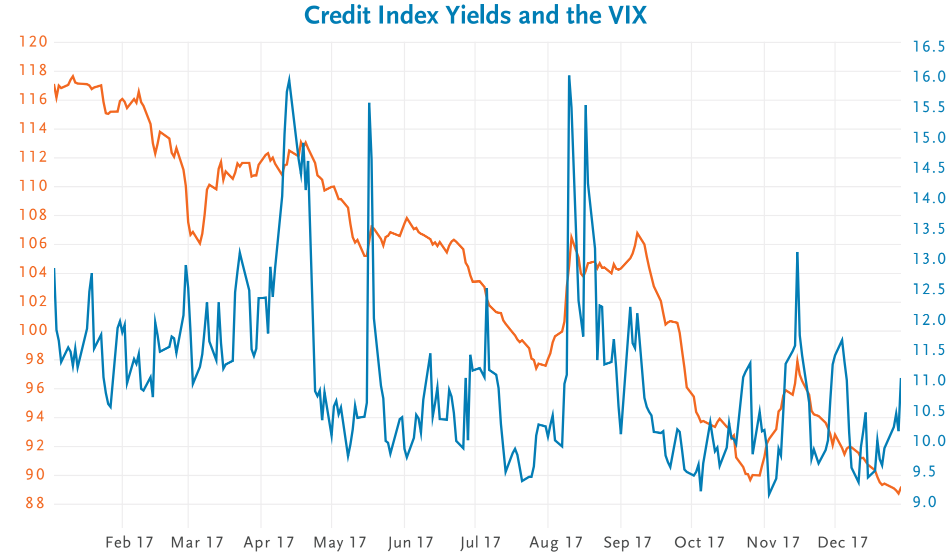
Ms. Karp is a Managing Director in the Fixed Income group where she trades investment grade and cross over securities. Ms. Karp joined TCW in 2009 during the acquisition of Metropolitan West Asset Management LLC (MetWest). Prior to joining MetWest in 1997, she was with the fixed income department at The Capital Group. Ms. Karp earned her BS in Business from University of Arizona.

2017 Credit Themes: Low volatility, tight spreads, peak leverage, continued remediation in commodity sectors, beta compression, record IG supply and demand (inflows into HG funds), flatter credit curves (despite a flatter Treasury curve), idiosyncratic risks in sectors like retail, AMZN threat (grocers, retail, pharmacies, drug distributors), and M&A failures due to antitrust concerns (AET/HUM, RAD/WBA, CI/ANTM and potentially ATT/TWX).

Low Volatility: It was a slow grind tighter in 2017 as spreads traded in a 29 basis point (bp) range (vs. 83 bp range in 2016). The IG Index experienced only two months of moderate negative excess returns and only one month of any meaningful widening (+6 bps in March). VIX at the lows.

Credit Index Yields and the VIX

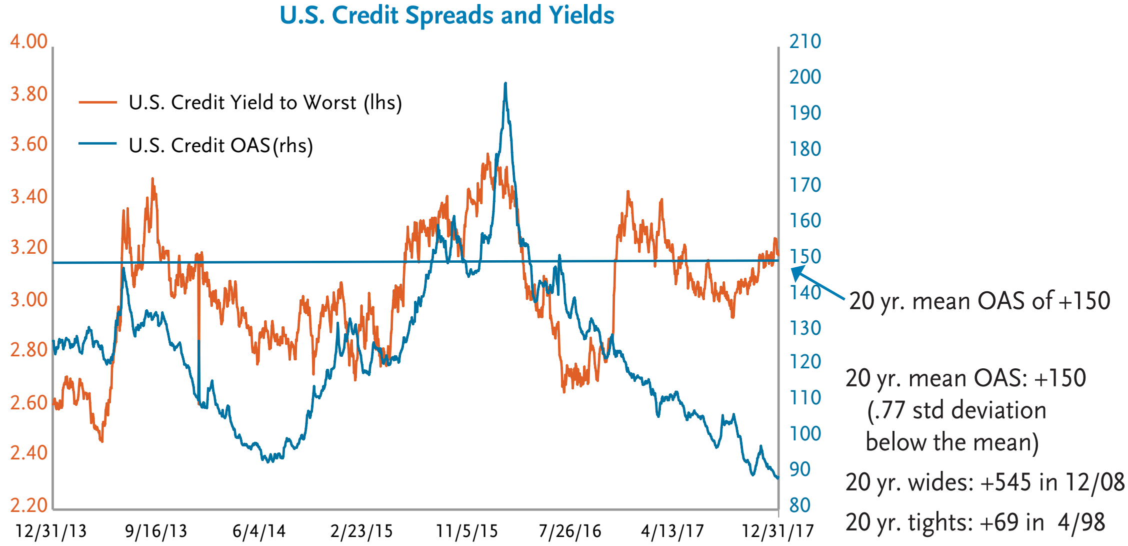


Key	Axis	Name	Last	Minimum		Maximum	
(blue)	Right	VIX	11.040	9.140	11/03/2017	16.040	08/10/2016
(orange)	Left	U.S. Credit – OAS	89.149	88.744	12/28/2017	117.656	01/11/2017

Source: Bloomberg Barclays

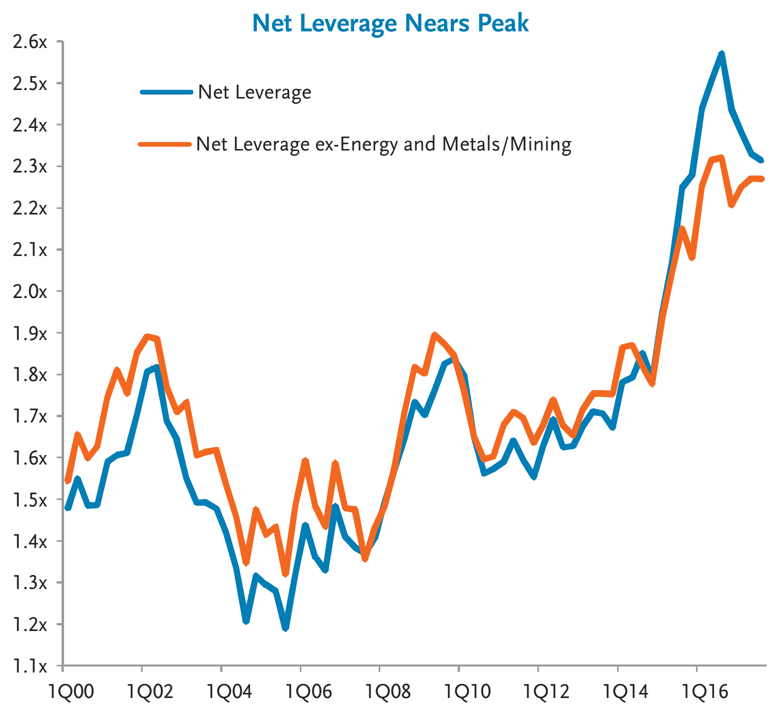
Valuations: Spreads ended the year at post crisis tights and well through historical mean (20 yr. mean OAS +150).

U.S. Credit Spreads and Yields



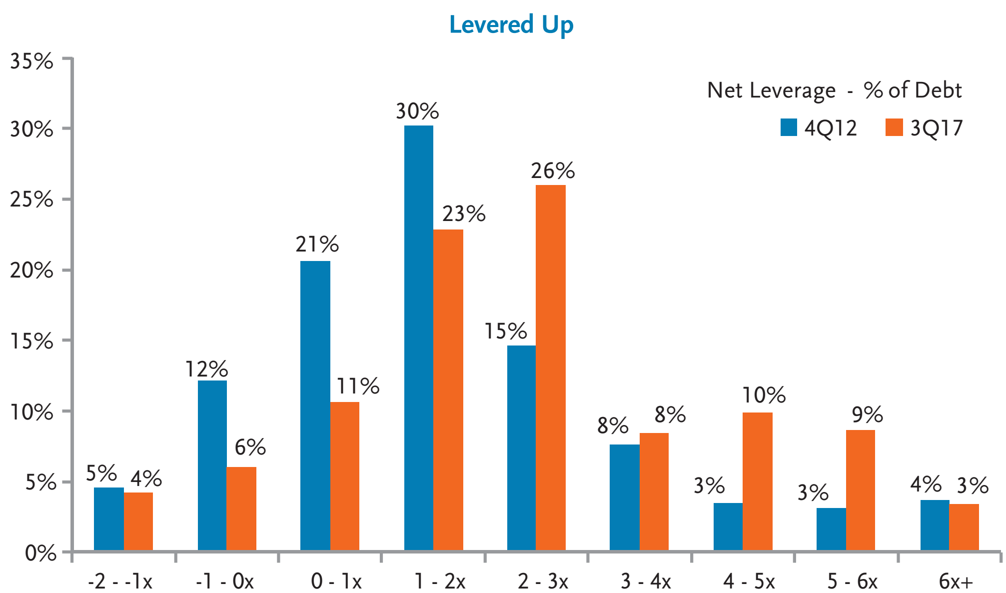
Source: Bloomberg Barclays

Fundamentals: Net leverage as of the end of 3Q17 was 2.31x – very close to all-time high of 2.57x set in 3Q16.



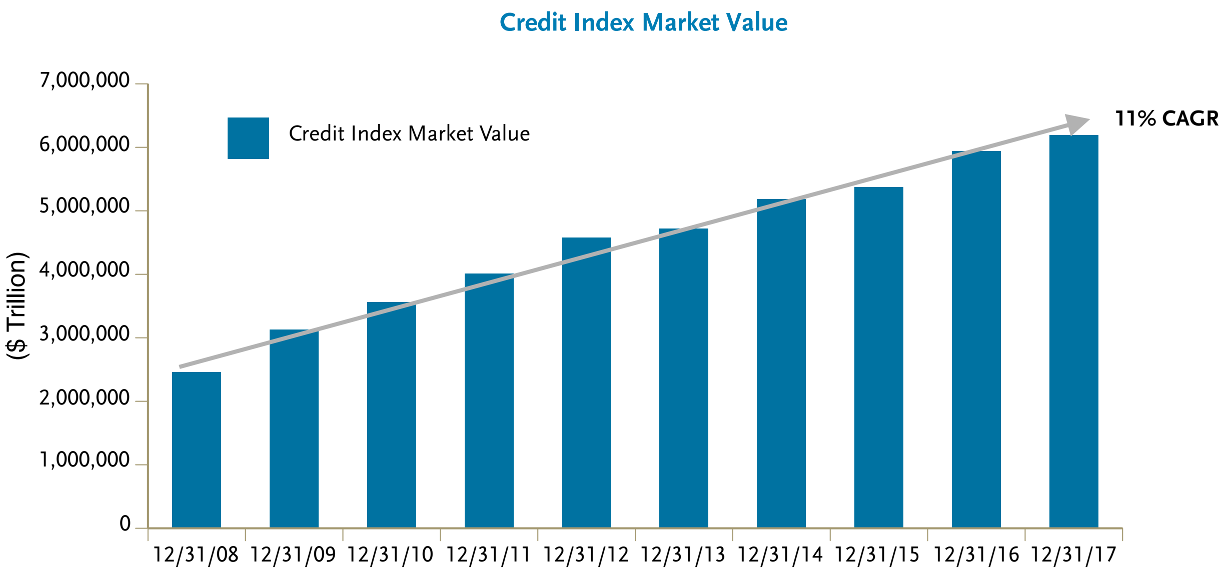
Source: JP Morgan

Some 30% of the non-financial IG universe (by market value) is more than 3x levered. A full 12% is more than 5x levered.



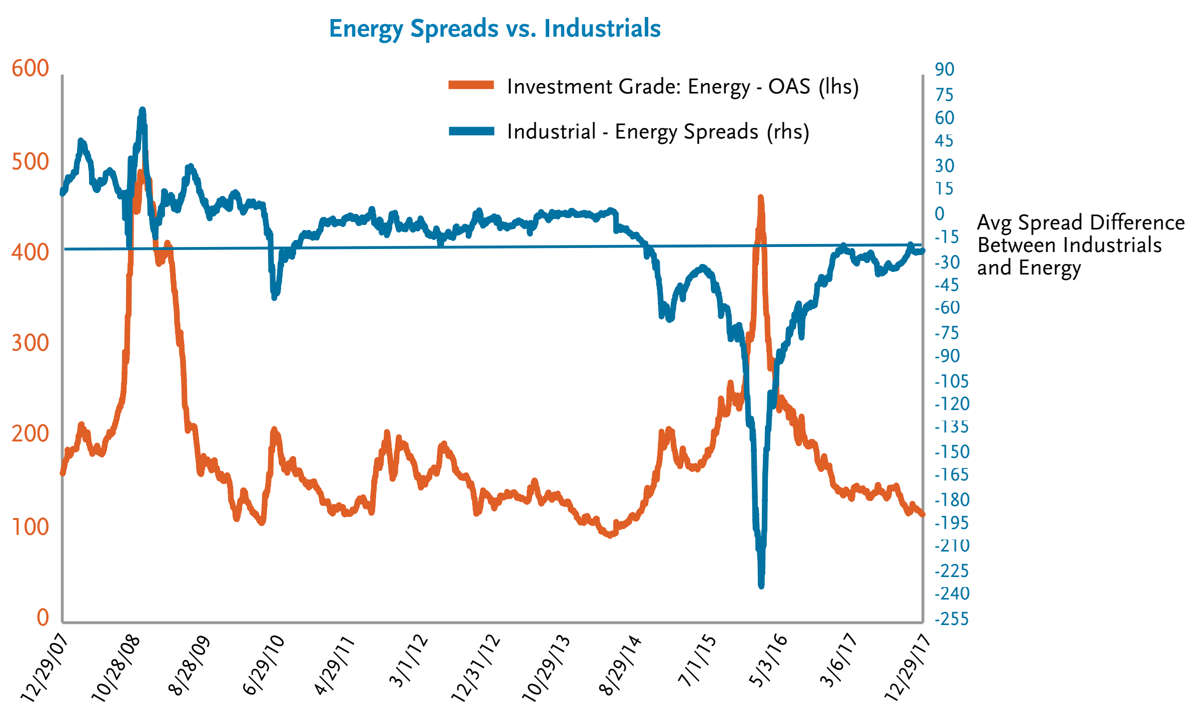
Source: JP Morgan

IG Credit Markets Have Grown $3.7 trillion since 2009 – 11% CAGR.



Source: Bloomberg Barclays

Remediation in commodity-related sectors: Energy spreads are in line with their historical mean vs. industrials.

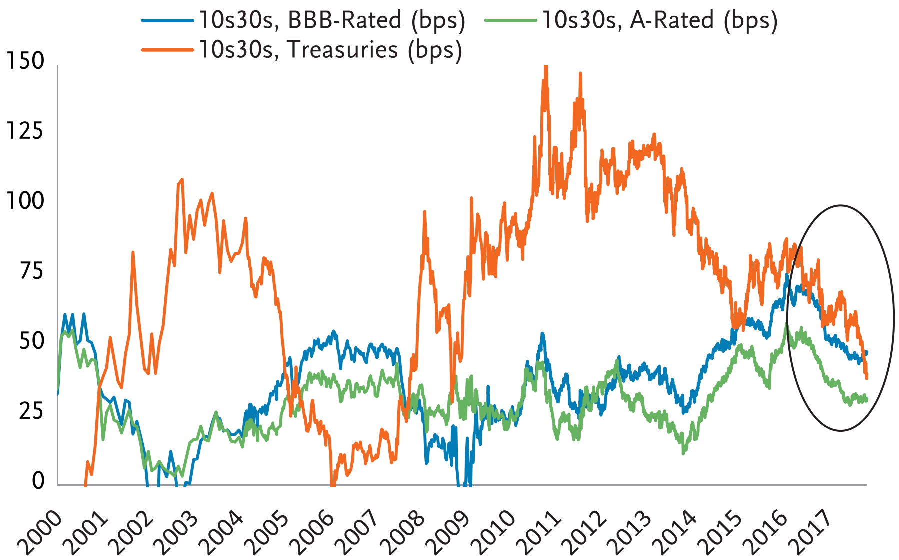


Source: Bloomberg Barclays

	12/29/17	Min	Max	Mean
Industrial - Energy Spreads	-21	-232	68	-16

Credit curves; 10-30's credit curves (non financial) have flattened 10 bps YTD, despite 22 bp flatter Treasury curve.

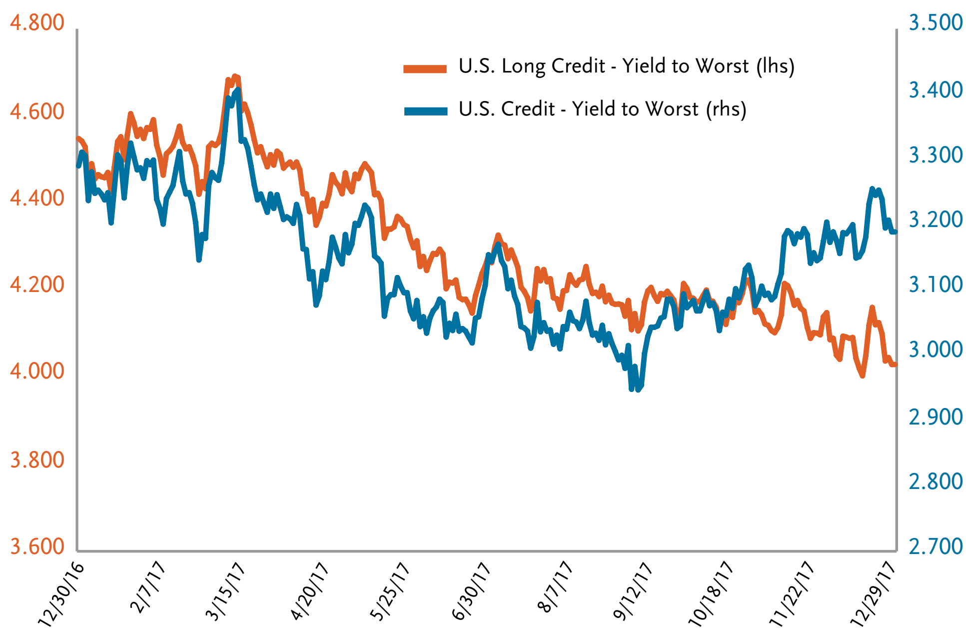
10-30's Credit Curves



Source: Bloomberg Barclays, BofA Merrill Lynch Global Research

Long end credit yields were 52 basis points lower on tighter spreads and long end rate rally.

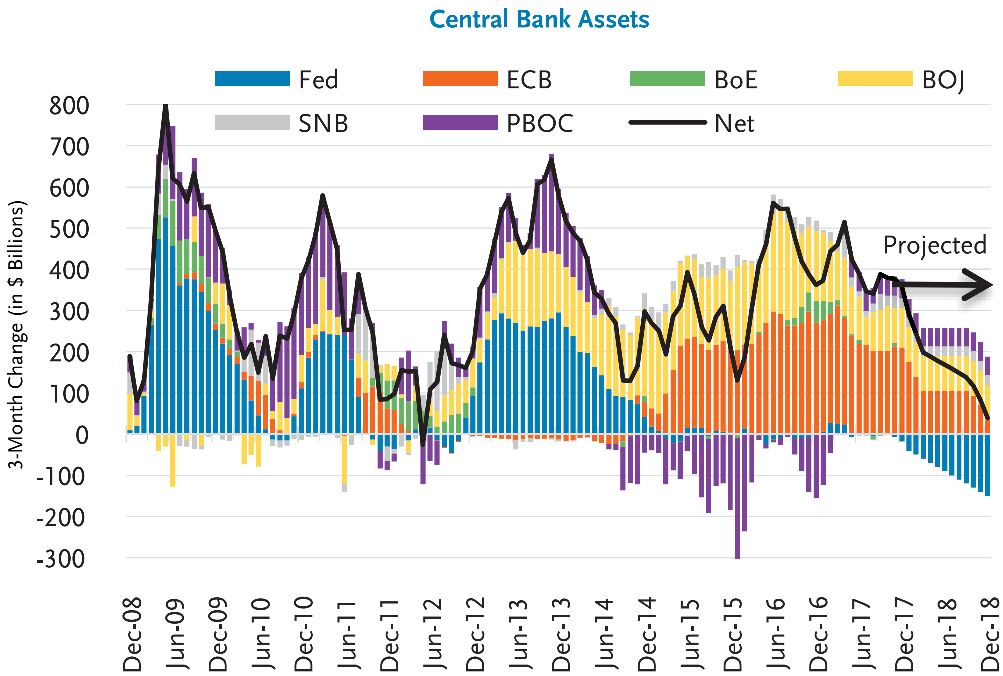
Credit Index Yields



Source: Bloomberg Barclays

	12/29/17	12/30/16	YoY change
Credit Index Yield	3.19%	3.29%	-0.10%
Long Credit Index Yield	4.03%	4.55%	-0.52%

QE has been a major tailwind for the credit markets. But that stimulus is expected to dissipate as central banks unwind balance sheets.



Source: Wells Fargo Securities, Bloomberg L.P.

Sector performance: The investment grade credit index tightened 29 bps in 2017, ending the year at an OAS of +89 bps over Treasuries. It was a new post crisis best and well through the 20-year average of 150 bps. The OAS range also measured 29 bps as spreads grinded tighter with very few hiccups. Returns were strong at 6.18% on tighter spreads (-29 bps) and modestly lower yields (credit index yield of 3.19% vs. 3.32%). Curves continued to flatten despite a large flattening of the Treasury curve (10s-30s Treasury curve 28 bps flatter). The 10s-30s credit curve for BBB non-financials flattened 11 bps to 48 bps (closer to the historical average of 44 bps) while single A 10s-30s curve flattened 7 bps to 30 bps (historical average of 33 bps). As a result, the yield for the long credit index fell by 52 bps (from 4.55% to 4.03%), posting a total return of 12.21%.

Higher beta outperformed, with BBB's tightening 36 bps on the year while single A credit tightened 28 bps. Every sector in the credit index posted positive excess returns. Metals and mining was the best performing sector for the second year running, tightening 66 bps to end the year at an OAS of 139. Overall, the commodity-related sectors, including energy outperformed again in 2017 as prices remediated. Within energy, the best performing sub sectors were refiners (-58 bps) as product demand/margins remained strong and independents (-35 bps) which tend to be higher beta and more sensitive to the move in oil prices. The biggest underperformers were consumer products (-18 bps), supermarkets (-18 bps), and diversified manufacturers (-15 bps), though even the worst performing sectors were tighter on the year. Other sectors that performed below average include retailers (-19 bps) and wirelines (-10 bps). The wireline sector is dominated by two names, AT&T and VZ, which are the largest industrial issuers in the credit index by market value (1.7% and 1.31% respectively). The underperformance has been driven by continued supply in the sector, as M&A-related issuance has pressured those issuers with already large capital structures – specifically AT&T, which issued $22.5 billion bonds back in July to fund the TWX acquisition (which the DOJ is attempting to block). For retailers, performance was bifurcated with pharmacies (CVS, WBA) and department stores (JWN, M) underperforming and discounters (WMT, DG) outperforming. The Amazon threat has impacted spreads for several industries, including big box retail, grocery stores, drug retail and drug/medical distribution. It has also given rise to M&A transactions (like CVS/AET) as companies look to add scale and vertical integration as a way of diversifying and competing more effectively.

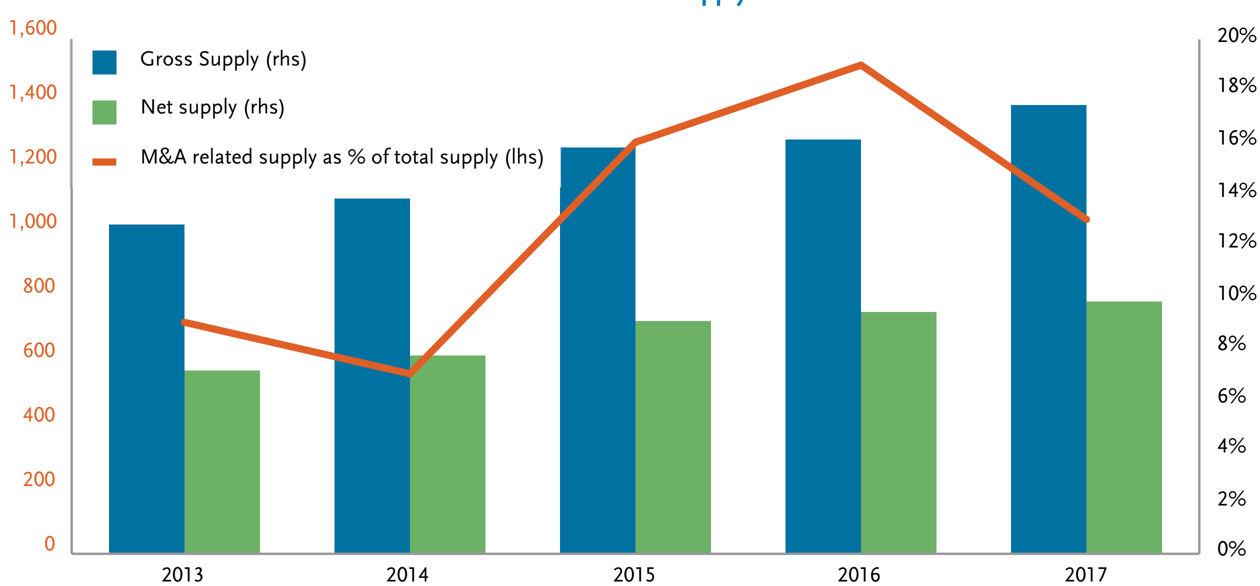
2017 Index Performance

	Year-to-Date Total Return	Year-to-Date Excess Return	Option-Adjusted Spread	Option-Adjusted Spread Change
Credit Index	6.18%	3.35%	89	-29
Industrials	6.71%	3.49%	98	-27
Financials	5.60%	3.43%	85	-35
Utilities	7.59%	3.41%	92	-25
Munis	10.84%	5.92%	149	-32
Sovereigns	9.14%	5.58%	105	-50
A's	5.98%	2.96%	73	-28
BBB's	7.45%	4.47%	124	-36
Best performing sub sectors:				
Metals	15.20%	11.24%	139	-66
Energy: refining	10.98%	7.14%	120	-58
Paper	9.21%	6.07%	119	-52

Source: Bloomberg Barclays

2017 IG Supply: Investment grade issuance hit another record in 2017 with an eye popping $1.396 trillion in deals printing, an increase of 8% vs. 2016. M&A-related issuance of $184 billion (13% of total) was down 23% from last year's record number. Still, total supply set new records as nearly every sector (with the exeption of 4) grew on YoY basis. The biggest increases in supply came from Banks (up 12%), Telecom/Wirelines (up 113%) and Basics (+95%). For domestic Banks (i.e., U.S.) issuance saw a large 20% increase, though keep in mind that increase was spread across many issuers. Telecom/Wireline issuance was dominated by AT&T, Printing a whopping $33 billion in new debt, about half of the total telecom supply. For Basics, the big increase was largely due to M&A-related deals, including SHW and MOS. Biggest YoY decreases in supply came from Food and Beverage and Pharma/Healthcare due to lower M&A related supply.

Annual IG Supply



Source: BofA Merrill Lynch

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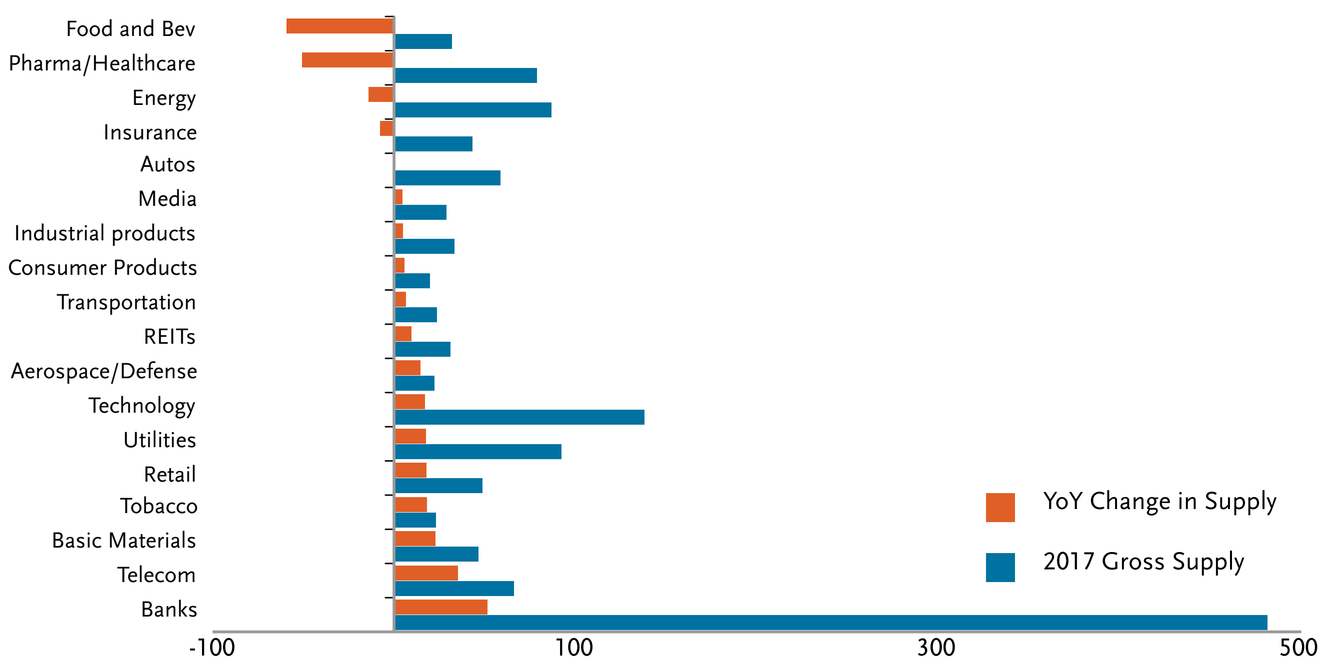
Gross Supply Stats ($bn)

	U.S.	Other DM Europe	Yankee	EM	Total	Change vs. 2016
Banks/Brokers	231	115	122	13	481	52
Other Financials	85	4	9	3	101	11
Total Financials	**316**	**118**	**130**	**17**	**583**	**63**
Industrials	**557**	**73**	**27**	**63**	**720**	**26**
Utilities	**65**	**10**	**0**	**17**	**92**	**17**
Total	**938**	**201**	**157**	**97**	**1395**	**106**

Source: BofA Merrill Lynch

2017 Gross Supply by Sector and YoY Changes



Source: Bloomberg Barclays

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